BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WURM-WOVEN HOSIERY MILLS)

Appearances:

For Appellant: Mr. W. B. Bailey, Certified Public Accountant

For Respondent: Hon. Chas. J. McColgan, Franchise Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Stats. 1929, Chapter 13, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Wurm-Woven Hosiery Mills, a corporation, to a proposed assessment of an additional tax in the amount of $461.26 for the year ended December 31, 1931.

The appellant is a corporation incorporated under the laws of this state. Its business consists of manufacturing hosiery at a plant located in this state. Appellant owns 100% of the stock of the Form-Fashion Hosiery Co., a corporation incorporated under the laws of Nevada and having its principal office in Reno, Nevada. All the goods manufactured by the appellant are sold to its subsidiary, Form-Fashion Hosiery Co., under contract with said company, and are shipped to it in Nevada. The subsidiary in turn retails the goods so sold to it.

Within two months and fifteen days after the close of the year 1930, a consolidated return was filed by the appellant and the Form-Fashion Hosiery Co. showing that appellant had realized a net income of $16,223.72 for the year 1930 from its manufacturing business, whereas the subsidiary had sustained a loss of $13,427.80 for the year from its sales business. The Commissioner disallowed the loss of the subsidiary, and as a result of so doing, proposed the additional assessment in question.

The appellant contends that under Section 14 of the Act, it and its subsidiary were entitled to file a consolidated return for the year 1930, and that consequently, the loss of the subsidiary should have been allowed by the Commissioner.

Section 14 of the Act, insofar as it is relevant, provides as follows:

> "An affiliated group of banks or an affiliated group of corporations shall, subject to the provisions of this section,

> "have the privilege of making a consolidated return for any taxable *year* in lieu of separate returns."

There is no question but that the appellant and the subsidiary Form-Fashion Hosiery Co., are affiliated corporations. However, it does not appear that the subsidiary ever engaged in doing business in California or ever qualified to do business here. It is true that it engaged in an interstate business between Nevada and California inasmuch as some of the goods which it purchased from the appellant were shipped back into California pursuant to orders taken in California by agents of the subsidiary. It has been held, however, that a State cannot impose a franchise tax on a foreign corporation doing an exclusively interstate business (Alpha Portland Cement Co. v. Massachusetts, 268 U.S. 203). For this reason, and for the further reason that the Act purports to impose a tax only on corporations doing business in this state, it would seem that the Form-Fashion Hosiery Co. was not subject to the Act during the year 1931 and was not required to file a return thereunder for the year 1930. Consequently, it would seem that appellant and the Form-Fashion Hosiery Co. are not entitled to file a consolidated return under Section 14 of the Act notwithstanding the fact that they are affiliated corporations, since Section 14 permits the filing of consolidated returns in lieu of separate returns.

We are of the opinion that the above' conclusion is clearly correct inasmuch as it is apparently the purpose of the Act to impose upon corporations a tax for the privilege of exercising their corporate franchises in this state, to be measured by their net income derived from business done in this state. This purpose would not be accomplished if net income of corporations from business done in this state could be reduced by the amount of losses sustained by affiliated foreign corporations as the result of business activities engaged in outside of the state. Furthermore, if net income of foreign corporations not doing business here may not be used as a measure of a tax imposed by California, as is clearly the case, why should the losses of such corporations be considered for the purpose of reducing, in effect, taxes otherwise due the state from corporations doing business here?

Although the point was not raised by Appellant in its brief filed with this Board, the appellant contended in the oral hearing duly held before this Board in this appeal that the sum of $16,223.72 reported by appellant as net income from the operations of its manufacturing business in this state should not be considered for tax purposes as representing actual net income realized as the result of the operation by appellant of a factory in this state. This contention, we think, is necessarily predicated on the following assumptions:

That under the contract with its subsidiary, appellant sold the subsidiary goods at a price in excess of the actual value of the goods as evidenced by the fact that the subsidiary sustained a loss of $13,427.80 in re-selling the goods during the year 1.930; that inasmuch as appellant owned 100% of the stock of the subsidiary, the separate corporate existence of the subsidiary should be disregarded with the result that appellant should be considered as directly operating the business of the subsidiary; that the business of manufacturing and selling hosiery should be considered as a unit business; and that the Commissioner, if the above assumptions are true, should disregard the fact that the appellant's books of account showed a net income of $16,223.72 for the year 1930 and should compute appellant's actual income from its manufacturing business on some other basis than its books of account.

If the selling end of the business had been directly engaged in by appellant rather than by a separate subsidiary corporation, and if separate books of account had not been kept for the manufacturing and the selling ends of the business, the amount of net income properly attributable to the manufacturing part of the business would have had to be determined by the application of an allocation formula to the amount of net income realized from the entire business, and in this case would have amounted to some fraction of the sum of $2,795.92, i.e. the difference between the loss of $13,427.80 reported by the subsidiary and the gain of $16,223.72 reported by the appellant. On the other hand, if appellant had sold the goods it manufactured to a corporation in which it owned no stock, for example, rather than to its wholly owned subsidiary, the entire amount realized by appellant from the sales would have to be considered as net income attributable to the manufacturing of the goods regardless of whether the buyer was able to resell the goods at a profit or at a loss. The same result, we think, will have to be obtained if the contract under which appellant sold to its subsidiary should be considered as the same kind of contract appellant could have entered into with a corporation, for example, in which appellant owned no stock.

Thus it would seem that we could give appellant relief only by holding that the separate corporate existence of the subsidiary should be disregarded, and further by holding that under the contract with its subsidiary, appellant received more for the goods sold than it could have otherwise received,

It is too well settled to need citation of authority that the existence of a corporation should not be lightly disregarded. It is true then in proper cases such as the prevention of tax evasion or fraud, courts will look behind the corporate structure to determine what is actually taking place. But we know of no authority for the proposition that a corporation may demand that the separate existence of a subsidiary should be disregarded for the sole purpose of

reducing taxes otherwise due. Furthermore, appellant has not established that it received from its subsidiary a greater amount for the goods it manufactured than it would have otherwise been able to obtain. The fact that the subsidiary sustained a loss during the year 1930, alone considered, is not a sufficient showing that the contract under which it purchased the goods was an unfair contract insofar as it was concerned. It is certainly conceivable that in another year with different business conditions, or with different management, the subsidiary might be able to reap a considerable profit from the resale of goods purchased from appellant. It should also be noted that appellant has not satisfactorily explained why the particular contract it made with the subsidiary was made unless at the time of making it the contract was considered a fair one.

For the above reasons, we are unable to say that the Commissioner erred in considering as net income of the appellant for the year 1930 the sum of $16,223.72 reported by appellant and shown on appellant's books of account as net income for the year 1930.

O R D E R

Pursuant to the views expressed in the opinion of the Board of Equalization on file in this proceeding, and good cause appearing therefor,

IT Is HEREBY ORDERED, ADJUDGED AND DECREED that the actio of Honorable Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Wurm-Woven Hosiery Mills, against a proposed assessment of additional taxes under Chapter 13, Statutes of 1929 as amended, based upon the returns of the above company for the taxable year ended December 31, 1930, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of October, 1932.

R. E. Collins, Chairman
Fred E. Stewart, Member
Jno. C. Corbett, Member
H. G. Cattell, Member

Attest: Dixwell L. Pierce, Secretary